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November 12, 2002

REDACTED FOR PUBLIC INSPECTION

By Courier

Marlene **H.** Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
Room TW-A-325
Washington, D.C. 20554

Re: In the Matter of Verizon Telephone Companies Tariff FCC Nos. 1, 11, 14 and 16 Transmittal No. 226, WC Docket No. 02-317

Dear Ms. Dortch:

Enclosed please find an original and 4 copies of the Redacted Opposition of AT&T to Verizon's Direct Case that was filed today in the above captioned proceeding. Confidential portions of the opposition will be filed separately.

Please feel free to call if you have any questions.

Very truly yours,

Patricia A. Bunyasi

Patricia A. Bunyasi
Legal Assistant

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Before the
FEDERAL COMMUNICATIONS COMMISSION
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AT&T CORP.
OPPOSITION TO DIRECT CASE

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November 12, 2002

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FEDERAL COMMUNICATIONS COMMISSION
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AT&T CORP
OPPOSITION TO DIRECT CASE

Pursuant to the Investigation Order (*"Investigation Order")* in this matter released on October 7, 2002, by the Chief of the Pricing Policy Division, AT&T Corp. ("AT&T") hereby submits its Opposition to the Direct Case tiled by The Verizon Telephone Companies ("Verizon") on October 29, 2002 ("Direct Case").

I. INTRODUCTION AND SUMMARY

This proceeding is the second investigation of a series of anticompetitive proposals by incumbent LECs designed to leverage the recent bankruptcy filings of several competitive local and long distance carriers to gain regulatory approval for radical new tariff provisions that the incumbents would use to disadvantage the remaining carriers that have sound credit and that pose no exceptional bad debt risk. Verizon's professed justification – which it never supports and is entirely unfounded – is that the "changing nature of the telecommunications market" has ended the "stable, low risk market of the 1980s" and has created a significant and "permanent" increase in Verizon's exposure to uncollectible bad debts for interstate access services. Verizon's direct case does not come close to establishing a need for any such tariff revisions.

Given the grossly excessive returns that Verizon and other large incumbent LECs achieve on access services, Verizon's plea for additional security is simply thinly disguised greed – and a stark effort to gain an anticompetitive weapon to use against its new long distance rivals In 2001, for example, a period in which Verizon claims that its bad debt uncollectibles rose significantly, Verizon earned about a l7 percent rate of return on interstate access and about **37** percent (excluding the NYNEX territories) on special access services. Given the hefty margins on services for which Verizon continues to enjoy near-monopolies. there is no need for the Commission to take additional steps to help Verizon maximize its access revenues.

In fact, Verizon's proposals are an incredibly overbroad response to a largely nonexistent problem, and they should be promptly rejected. No aspect of Verizon's provision of access services is particularly risky or volatile, and, as demonstrated below and in the accompanying declaration of Dr. Bradford Cornell, Verizon continues to enjoy very low ***actual*** levels of bad debt expenses that are in no way indicative of any permanent bad debt crisis that is beyond the capabilities of Verizon's existing tariff provisions

In this regard, Verizon has grossly exaggerated its claims that the recent downturn in the market has exposed it to substantial liability from unpaid access bills. The ***ARMIS*** data reported by Verizon's bad debt expense remain generally less than one percent and never higher than I.25 percent. The recent fluctuations in Verizon's uncollectibles are modest and consistent with prior variations, and simply result from normal fluctuations in the business cycle or from other short-term market conditions. **[begin proprietary]**

[end proprietary]

In these circumstances, the Commission's price cap system already accounts fully for these potential uncollectibles expenses Under the price cap system, any year-to-year fluctuations to bad debt expense are considered business risks that the LEC must absorb (just as Verizon retains the benefit of lower than average bad debt levels during periods of economic strength) Moreover, the Commission's existing prescribed tariff language already fully protects Verizon from customers with a proven history of non-payment, and from customers without established credit Verizon fails to explain why these provisions, which were in place in prior economic downturns, are no longer sufficient.

Verizon claims that it "needs these tariff protections" because it is seeking to implement credit provisions that are similar to those of companies in competitive industries, including the long distance market But Verizon is ***not*** a company operating in a competitive industry – it is a near-monopolist that, as the ***Investigation Order*** recognizes, provides the sole source of access services for most of the traffic handled by its customers. In that case, Verizon has no incentive to make "commercially reasonable" decisions when it applies even facially neutral credit provisions to its customers – instead, it will seek to eliminate any risk of uncollectibles by demanding enormous security deposits or advance payments, secure in the knowledge that its customers cannot choose an alternate supplier for access Companies in competitive industries, by contrast, are subject to rigorous, market-based checks in **how** they apply even vague credit provisions, because any unreasonable demands for large security deposits (like those at issue here) generally will cause customers to flee to more reasonable suppliers

Furthermore, even if Verizon had demonstrated some limited increase in its exposure that is not already appropriately covered by the Commission's price cap rules or by its longstanding tariff prescriptions relating to non-payment risks, Verizon's proposed tariff revisions are by no means a narrowly circumscribed and measured response to any such problem. Verizon seeks wide discretion to demand security deposits from its access customers based solely upon long-term bond ratings issued by three bond rating agencies However, Verizon has set the bar so low that virtually *all* non-BOC affiliated carriers in the industry are subject to security deposits, even though the bond agencies themselves report that, on average, the actual rate of default for companies with the ratings selected by Verizon is a miniscule ***4 percent*** – proof that Verizon's triggers are far too broad. Thus, Verizon will be able to eliminate ***any*** risk of uncollectibles by providing itself with the authority to demand massive deposits from virtually all carriers, even those with a minimal rate of default. For large IXCs, the amounts demanded as "security" deposits or "advance payments" could be hundreds of millions of dollars – easily enough to disrupt the business plans of even large carriers that are otherwise able to pay their bills.

As the *Investigation* ***Order*** (¶ 15) explicitly questioned, the anticompetitive effects of such a system are alarming. Verizon has designed its criteria so that its own long-distance affiliates are (predictably) creditworthy and need not provide a security deposit – even though, if Verizon were to treat those affiliates at arms' length as the Act's terms require, those affiliates would be precisely the types of companies with no established credit for which security deposits are appropriate. It is quite clear therefore that Verizon seeks to wield the proposed security deposit provisions as an anticompetitive and discriminatory weapon to disadvantage and raise the costs of the rivals to its new long distance business The Commission has repeatedly rejected similar proposals to grant Verizon and other incumbents wide discretion over payment and security deposit terms for that very reason, and these proposed tariff provisions, like previous attempts, should be rejected

II. VERIZON PROVIDES NO EVIDENCE OF ANY CHANGED CONDITIONS THAT WARRANT REVISION OF ITS EXISTING TARIFFS.

As the *Investigation **Order*** recognizes, Verizon's proposed tariff revisions "significantly alter" the balance of risk of nonpayment of access charges between Verizon and its captive access customers. *Investigation **Order*** ¶ 11. Accordingly, even before addressing the propriety of the specific tariff revisions proposed by Verizon, the preliminary question to which Verizon must respond in its direct case is "whether circumstances have changed" in a way that could justify any revision at all in the Commission's longstanding tariff prescription on security deposits. *Id.* Verizon's direct case on this fundamental issue is virtually non-existent, and its proposed tariff revisions should be rejected on this ground alone

A. Verizon's Bad Debt Risk Has Not Risen Significantly And Certainly Poses No Serious Threat Of Revenue Shortfalls.

Verizon claims that across-the-board tariff revisions are necessary because "changing nature of the telecommunications market" has created great "financial turmoil" in the industry that has changed the "stable, low risk market of the 1980s" so that there is a "permanent" and "extraordinary" increase in Verizon's exposure to bad debt expenses, such that it "need[s] more . . . protections." Direct Case at 2, 12-13. But Verizon provides *no* evidence that its access service business has become more risky, because the reality is quite different.[1] In fact, the excessive and increasing rates of return Verizon has earned over the last few years confirm that Verizon retains near-monopoly control over access markets and thus faces little risk of eroding revenues. Verizon is correct that access reform is needed, but the focus should be on *reducing* the Bell Operating Companies' market power abuses, not increasing their discretion and ability to fleece captive customers In any event, Verizon has not remotely demonstrated that its uncollectibles expense – particularly as a ratio of its rapidly increasing access revenues – has risen to significant or even unprecedented levels To the contrary, Verizon's uncollectibles expense as a percentage of revenues remains remarkably low. Verizon certainly has not shown that recent fluctuations in uncollectibles expenses are especially volatile or the result of some long-term trend, rather than reflective of general economic business cycles that are endogenous to the price cap regulation of access rates. And Verizon's claims of crisis arising from the bankruptcy filings of certain carriers is equally exaggerated: although Verizon does not provide precise figures, it seems likely that, excluding its claims relating to Global Crossing and WorldCom bankruptcies – which are

[1] Verizon's claim that marketplace risk prior to enactment of the Telecommunications Act "was relatively stable" and "low-risk' (Direct Case at 16) is equally misleading. For example, in 1989 and 1990, the level of the LECs' projected uncollectibles was expressly contested before the Commission, and several LECs contended that those projections were appropriate, relying for support on many of the very same arguments that Verizon makes today. Thus, SWBT claimed that its increases in its 1989 uncollectible ratios were appropriate because of the "floundering Texas economy," which, in SWBT's view, "has damaged the financial stability of many I[X]C's," and which, SWBT asserted, means that uncollectibles "can be expected to trend upward." ***In the Matter of Annual 1989 Access Tariff Filings,*** 4 FCC Rcd 3638, ¶ 558 (1989). Likewise, Pacific justified its 1990 increase in uncollectibles by claiming that "it forecasts a slowing economy in California and the United States," and by "argu[ing] that this is expected to exert downward pressure on its ability to collect accounts receivable and will increase uncollectibles." ***In the Matter of Annual 1990 Access Tariff Filings,*** 5 FCC Rcd. 4177, ¶ 387 (1990). In neither instance did these LECs' predictions come true, because the data indicates that the level of LEC uncollectibles remained extremely low in the early 1990s.

unique and non-recurring events precipitated by allegations of massive accounting fraud designed to fool investors and creditors – Verizon's bankruptcy claims for 2002 are no more significant than in past years

1. Verizon Continues To Reap Exorbitant Returns On Its Access Services.

Verizon's plea (at 5, 16) that it "needs these tariff protections" because it was "compelled by government fiat" to provide access services to supposedly uncreditworthy carriers ignores the numerous and significant benefits it obtained from that bargain: Verizon and other incumbent LECs were for years – and remain today – protected from any significant competition in the provision of access services, which has allowed them to continue to be the dominant providers of access services and earn exorbitant – and increasing – returns on those services. True, Verizon is compelled to provide access services,[2] but it did not complain about that bargain throughout much of the late 90s, as carriers and new entrants – who were equally compelled to purchase largely from Verizon – purchased more and more access, increasing Verizon's interstate access revenues from about $9.4 billion in 1996 to nearly $12 billion in 2001.[3] However, Verizon – which has steadfastly opposed efforts to open its access markets to true

[2] As the *Investigation Order* recognizes (¶ 11), the access market is and for years has "two distinct characteristics:" "Verizon must provide access services to IXCs and competitive LECs requesting such services, and those carriers must use Verizon's access services to originate or terminate many of their interstate calls." It is now Verizon which seeks to "significantly alter" the risks surrounding these two characteristics.

[3] *E.g.*, Verizon 2001 Annual Report, at 13 ("In 2000, growth in minutes of use from carriers and CLECs . . also contributed to network access revenue growth"); Verizon 2000 Annual Report at 18 (despite rate reductions in some access services, "network access revenues grew," which was "mainly attributable to higher customer demand, primarily for special access services"); Bell Atlantic 1999 Annual Report at 13 (reporting revenue growth despite some rate reductions; "growth was mainly attributable to customer demand," which "reflect[ed] a greater utilization of the network")

competition – now has the gall to complain about "limit[ations] in [its] ability to restrict service" to its access customers. even as it continues to reap increasing revenues and returns from those customers

In 2001, a period of time in which Verizon claims its uncollectibles rose to dangerous levels that it can no longer control with existing tariff provisions allowing it to require security deposits from customers with no or bad track records of payment, Verizon's own Form 492A demonstrates that it earned a 16.95 percent rate of return on its interstate access services [4] Verizon's rates of return on interstate access services were equally bloated in the previous two years. Verizon reaped a 16.85 percent rate of return in 2000 and a 16 7 percent rate of return in 1999, again despite increases in the absolute amounts of uncollectibles expenses in those years.[5] And, as AT&T recently demonstrated in a petition seeking reform of the regulation of incumbent LECs' special access rates, Verizon's earnings on special access services are even more excessive.[6] In 2001, for example, Verizon's own ARMIS reports demonstrate that Verizon earned just

[4] Verizon FCC Form 492A, Rate of Return Report (April 1, 2002). The overall rate of return for Verizon has been calculated as the sum of the net operating income for the local exchange carriers affiliated with Verizon Communications Inc. divided by the total net investment of these same carriers. in the attached declaration of Bradford Cornell, Professor Cornell reports a similar rate of return (17.08 percent) using Verizon's ARMIS reports Cornell Dec. ¶ 18 & Exh 3 (citing 2001 ARMIS 43-01, Table I, Cost and Revenue Table, Interstate, Column (h), Average Net Investment, Row 1910; 2001 ARMIS 43-01, Table I, Cost and Revenue Table, Interstate, Column (h), Net Return, Row 1915). The slight differences in the reported rates of return are due to the fact that ARMIS reports are filed earlier than the final Form 492 reports. Regardless of the source of the data, it is clear that Verizon's rates of return on access are excessive.

[5] Verizon FCC Form 492A, Rate of Return Report (filed April I, 2002 & March 30, 2002) (the 2000 and 1999 returns are calculated for the same LECs that were affiliated with Verizon in 2001); *cf.* Cornell Dec. ¶ 18 & Exh. 3 (under ARMIS report, rate of return for 2000 was 17 24 percent and for 1999 was 17.40 percent).

[6] AT&T Corp., Petition for Rulemaking, RM No. 10593 (filed October 15, 2002)

below a 22 percent rate of return on special access – and a 37 percent rate of return excluding the former NYNEX territory.' Verizon's special access rates of return (like those of every other BOC), moreover, have grown *every year* since 1996 – squarely refuting any claim that these services have become significantly more risky If the market for access services had in fact become more competitive and risky, then elementary economics dictates that revenues would be driven toward costs.'

Verizon's pleas that the Commission must immediately intervene to provide Verizon with additional "protections" designed to collect even more access revenues simply cannot be reconciled with the marketplace reality that Verizon's access revenues are already wildly excessive. Verizon seeks to capitalize on what it calls "a period of unprecedented financial stress and upheaval,"' in its ploy to gain authority to demand hundreds of millions of dollars in "security" from its interLATA competitors, but the evidence is clear that the industry downturn has not had any affect on Verizon's ability to earn monopoly profits in the provision of access services (and, particularly, special access services).

Verizon's real world access returns likewise refute any notion that changes in the Commission's longstanding tariff prescription on security deposits are necessary to

[7] *Id.* at **8** (Verizon earned 21.72% in 2001 and 37.08 percent excluding NYNEX, about two to three times the rate of return the Commission found just and reasonable in 1990 – which is itself far too high under current market conditions).

[8] *Id.* at 8-9. Moreover, these rates of return on Verizon's access services are in fact significantly *understated*, because the costs that Verizon reports on its ARMIS reports are its embedded costs. *Id.* at 10. Verizon's true costs of providing access services are the much lower, forward-looking economic costs. *Id.*

[9] Verizon Description and Justification, Transmittal No 226, at 6 (filed July 25, 2002) ("Verizon D&J")

ensure that Verizon's deposit requirements are "the same types" of "commercially reasonable protections that companies in other industries have."'[10] As its exorbitant returns demonstrate, Verizon is not operating in a competitive environment As described in Professor Cornell's declaration, in competitive markets, if the customer is not satisfied with the security deposit or other terms that a particular supplier demands, the customer can **seek** to obtain service from another provider. Cornell Dec ¶¶ 9, 30-31 The customer of a dominant LEC like Verizon, by contrast, generally has no such choice (*id.* ¶ 31; ***see also*** *Investigation* ***Order*** ¶ 11) – which is why the Commission has always recognized the need for prescription in this context that minimizes dominant LEC abuse of security deposit, advance payment and termination requirements. Because Verizon clearly retains substantial market power in the provision of access services, it retains the incentive and ability to impose unfair and discriminatory terms and conditions, like the security deposit revisions it proposes here – both to increase its own revenues, and, as it increasingly gains section 271 authority, to raise its long distance rivals' costs. Cornell Decl. ¶¶ 9-10, 26, 29-31.

For these reasons, there is no merit to Verizon's claim that the tariff provisions of some long distance carriers – which Verizon asserts contain "similar or broader criteria" for requiring a security deposit than Verizon's proposals – "constitute[] strong evidence" that Verizon's criteria are "market-based and reasonable."[11] However broad the language

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[10] ***See*** Direct Case at 1; ***id.*** at 5-8. As described below, Verizon's particular tariff revisions on security deposits are *nor* in fact **like** those of companies in competitive industries – companies in competitive industries cannot generally **seek** to impose more onerous credit terms on customers during an economic downturn. And companies in competitive industries do not demand security deposits from large customers solely based upon the customer's long-term bond rating, as Verizon proposes.

[11] Direct Case at 5-6

in these long distance tariffs, these carriers – unlike Verizon – will necessarily be checked by competitive market forces in how those terms are applied to customers, which will assure that security deposit demands are reasonable.[12] Nothing in Verizon's tariff provides those same assurances, because carriers are compelled to purchase Verizon's access services in most cases

2. Verizon's Uncollectibles Are Small Relative To Revenues, And Have Not Varied Substantially Over Time.

Verizon's proposed tariff revisions are also plainly unsupported because Verizon has not even shown that it is experiencing any significant or sustained increase in its uncollectibles expenses Verizon's claims (at 12-13) that it has incurred significantly higher costs due to "extraordinary carrier uncollectibles" is simply misleading. In fact, Verizon's bad debt levels, like those of other large LECs, remain very small in comparison to revenues. Moreover, the levels of uncollectibles fluctuate from year-to-year, depending on a number of factors including general economic conditions and the particular LEC's efficiency in collecting bad debts. The recent and modest increases in bad debt levels experienced by Verizon reflect business cycle fluctuations and other temporary events, and not any permanent trend that substantially increases the *future* risks of nonpayment

The principal data that Verizon provides in response to the *Investigation Order's* requests (¶ 12) for Verizon's uncollectibles levels is a chart that lists the absolute amount

[12] In all events, it is significant that the AT&T tariff that Verizon cites (Direct Case at 5 (citing AT&T Tariff FCC No. 30 § 3.5.5.(A)) is the tariff that governs AT&T's provision of service for a maximum of 30 days to customers that sign up for AT&T service without a standard service agreement. In light of the mandatory detariffing of basic long distance services. AT&T is required to provide services after 30 days via a service agreement. Thus, the practical impact of the language cited by Verizon is limited, and that tariff is not at all analogous to Verizon's access service tariff.

of interstate uncollectibles expense from 1990 to 2001. Direct Case at 13 & Exh **A-I** Based on this single chart, Verizon asserts that "interstate uncollectibles increased" by "445% and ***375%*** in the East and West respectively." Direct Case at 13 Verizon further claims that this "enorm[ous] growth'' is made more evident by the fact that interstate access revenues grew by only 35% and 65% in the East and West in the same period. *Id.* Verizon's data, and especially its claims about that data, are highly misleading, for a number of reasons.

Most significantly, Verizon relies largely on the absolute amount of interstate uncollectibles, but – except for its one misleading comparison – fails to compare those figures to its interstate access revenues. The relevant measure of uncollectibles expense is, of course, the *percentage* of revenues that is uncollectible **As** shown in the following table, Verizon's uncollectibles ratios (uncollectibles expense divided by interstate access revenues) are quite small, and have ***never*** reached 1 **25** percent of revenues.

Verizon Interstate Uncollectibles Data As A Percentage of Interstate Revenues 1990-2001[13] Table 1			
Year	**Interstate Access Uncollectibles (000s)**	**Interstate Revenues (000s)**	**Uncollectible Ratio**
1990	31,097	8,301,562	**0.37%**
1991	34,939	8,299,098	**0.42%**
1992	42,812	8,491,367	**0.50%**
1993	45,171	8,648,924	**0.52%**
1994	55,281	8,871,493	**0.62%**
1995	58,250	9,141,335	**0.64%**
1996	47,447	9,405,801	**0.50%**
1997	42,354	9,691,684	**0.44%**
1998	42,242	10,312,928	**0.41%**
1999	62,008	10,760,672	**0.58%**
2000	65,403	11,317,315	**0.58%**
2001	138,705	11,814,418	**1.17%**

As these figures confirm, Verizon is **not** suffering from any bad debt "crisis." Its level of uncollectibles is low by virtually any measure, and even the modest increase in the year 2001 still have not placed any substantial percentage of Verizon access revenues in jeopardy In fact, the interstate uncollectibles ratio for Verizon West ***declined*** in 2001, to 0.77 percent – the same level as in 1995 and ***less*** than the ratio for 1991 or 1992. ***See*** Exh. 1, Table 2. **[begin proprietary]**

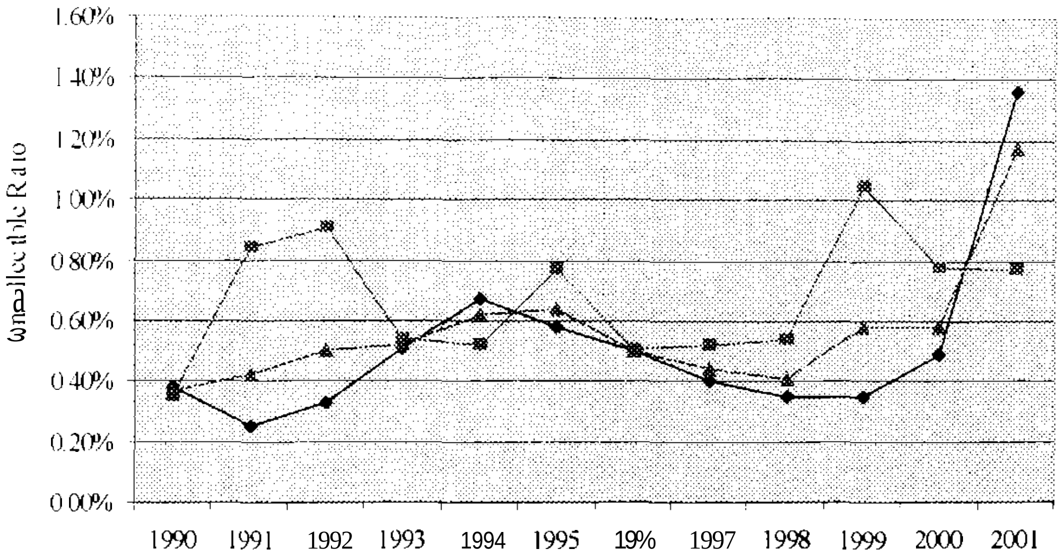
[end proprietary] And in all events, as described above,

[13] 1990-2001 ARMIS, 43-01, Table I, *Cost* and Revenue Table, Interstate, Row 1060, Uncollectibles; 1990-2001, ARMIS, 43-01, Table 1, *Cost* and Revenue Table, Interstate, Row 1090, Total Operating Revenues This data shows total figures for both Verizon East and Verizon West Separate tables for those territories are attached as Exh I (Tables 2 and 3)

these recent slight increases in bad debt have still had no cognizable negative impact on Verizon's ability to earn just and reasonable returns – indeed, Verizon continues to reap exorbitant rates of return on its access services

Nor can the mere fact that there have been fluctuations in the year-to-year levels of uncollectibles expense justify any tariff revisions. Verizon's uncollectibles expenses have always fluctuated over time **As** Professor Cornell explains (¶¶ 8, **12,** 14-17), this is entirely normal and the result of a variety of factors, such as general economic conditions and Verizon's efficiency at collecting its debts, and, as explained below, it was anticipated by and accounted for in establishing price caps. Thus, as shown in Table I and in the attached chart, from 1990 through 1995, Verizon experienced increases in its uncollectibles ratios, from 0 37% percent in 1990 to 0.64 percent in 1995. However, in 1996, 1997, and again in 1998, Verizon's uncollectibles ratio declined, back down to 0.50 percent in 1996, to 0.44 percent in 1997, and to 0.41 percent in 1999.

Verizon Uncollectibles Ratios



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Verizon East	0.38%	0.25%	0.33%	0.51%	0.67%	0.58%	0.50%	0.40%	0.35%	0.35%	0.49%	1.36%
Verizon West	0.35%	0.84%	0.91%	0.54%	0.52%	0.77%	0.51%	0.52%	0.54%	1.05%	0.78%	0.77%
Verizon Total	0.37%	0.42%	0.50%	0.52%	0.62%	0.64%	0.50%	0.44%	0.41%	0.58%	0.58%	1.17%

Year

As these figures demonstrate, there is no valid basis for Verizon's claims that it has experienced significant and permanent growth in its uncollectibles. And as Professor Cornell explains, the 2000 and 2001 fluctuations are not significantly different than prior fluctuations and could not support any reasoned conclusion that there is a long-term trend of increased uncollectibles expense Cornell Decl. ¶¶ 12-17.

These uncollectibles ratios also show that there is no basis to credit Verizon's claims that growth in uncollectibles is significant even "by comparison [to] interstate access revenues." Direct Case at 13 As a ratio, there is no doubt that bad debt uncollectibles are – and have been – quite small compared to overall revenues. Verizon misleadingly compares the *percentage growth* of uncollectibles to the percentage growth for interstate revenues, and proclaims that the growth of uncollectibles significantly outpaces revenue growth Direct Case at 13 That comparison has an obvious flaw – interstate revenues are much, much higher in absolute terms than uncollectibles, and thus any percentage change in uncollectibles will necessarily be larger than percentage change in revenues.

Beyond these errors, even the absolute figures on interstate uncollectibles that Verizon presents are misleadingly high[14] Those figures include bad debt for access services attributable to end users, which is plainly not relevant to the security deposits Verizon is seeking to impose on carrier customers. From Verizon's ARMIS reports, it is not possible to determine precisely the amount of end user uncollectibles compared to uncollectibles caused by wholesale customers~However, if end user customers default at approximately the same rate as carrier customers (and, excluding aberrations like MCI WorldCom, end user customer default rates may well be higher),'' it is clear that Verizon's absolute figures on interstate uncollectibles overstate the amount of wholesale customers' uncollectibles. In the year 2001, for example, Verizon claims that its interstate access uncollectibles were about $28 million for Verizon West and $1 10

[14] Verizon also makes vague and unsupported claims that its "total" uncollectibles for 2001 and 2002 exceeded **[begin** proprietary] **[end** proprietary] Direct Case at Exh. A-2. Again, Verizon fails to provide the relevant information on its revenue that is necessary to judge properly any trend in bad debt expense. Moreover, and in all events, those total uncollectibles include all types of bad debts that bear no relation whatsoever to the issues in this proceeding about the propriety of demanding millions of dollars of security deposits from access customers. For example, uncollectibles relating to interconnection agreements would likely involve payments for **unbundled** network elements, issues which go well beyond the interstate access services at issue here.

[15] Verizon claims that end user access uncollectibles increased much more slowly than carrier uncollectibles, but its analysis is based on an undisclosed "internal calculations," which simply cannot be credited.

million for Verizon East But if end user customer default rates are approximately the same as carrier default rates, about $10 5 million of the Verizon West total and about $40 million of the Verizon East total is attributable to end users, and only the remaining $17.8 million for Verizon West and $70 million for Verizon East is attributable to wholesale customers

Verizon also points to the amounts of the claims that it has asserted in bankruptcy proceedings since 2000 as evidence that its risks of nonpayments have greatly increased in recent years.[16] Those tigures are both seriously flawed and ultimately not indicative of the risks of nonpayment at which security deposit provisions are targeted. First, as Verizon concedes (Direct Case at 7), many of these bankruptcy proceedings remain open, and Verizon cannot determine the amounts that it will recover from the bankrupt entities. Thus, the amounts of the claims presented by Verizon significantly overstate actual uncollectibles.” Second, the amounts include both pre-petition ***and*** post-petition debts, but the security deposits and advance payments at issue would mitigate only pre-petition debts. Thus, including post-petition debts simply overstates the amount at risk that even

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[16] Direct Case at 7, Exhibit A at A-23

[17] And in fact, by virtue of its status as a dominant supplier of access, Verizon has a superior position that makes it more likely to obtain recovery of its claims in bankruptcy. A bankrupt entity's executory contracts can be assumed and assigned pursuant to 11 U.S C §§ 365(b)(1) and (f)(1) if the debt associated with such contracts is cured, or paid. Because the LECs' access services are typically the only option available, a company emerging from bankruptcy or a company acquiring all or part of a bankrupt entity will often seek to assume the existing LEC access services. In that instance, as a condition for the assumption and assignment of the access services, the bankruptcy code provides for payment of both the pre-petition and post-petition claims. Thus, there is no basis to presume that Verizon will not ultimately obtain payment for significant amounts of access it has claimed in bankruptcy proceedings. Although Verizon claims that it has to date collected about **[begin proprietary]**

(end proprietary] *The* ability to recover access services may be higher.

theoretically could be cured by additional security deposits. Third, the amounts of the claims presumably include the value of *all* of the services that Verizon provided to these carriers, and not merely access services – which again results in a significant overstatement of the relevant uncollectibles expense Fourth, unlike BellSouth, Verizon fails to show the amounts by year or amount for each bankrupt estate, which makes any analysis of Verizon's claims impossible However, if BellSouth's figures are any guide, the amounts claimed in bankruptcy are generally quite small, apart from the amounts relating to the bankruptcies filed by MCI WorldCom and Global Crossing. And those bankruptcies have been linked to massive and unprecedented instances of accounting improprieties. It would obviously be improper to base future policy that will affect all customers on such aberrations that are both unlikely to be repeated (given the serious tightening of accounting and related regulation by the Securities and Exchange Commission and other regulators) and not redressible through security deposit provisions (which Verizon concedes must rely upon what is reported and cannot account for what is hidden or misrepresented) [18] With those two claims removed, Verizon's bankruptcy claims would likely be drastically reduced.

The *Investigation* ***Order*** seeks to determine whether Verizon can demand security deposits from remaining ***viable*** carriers. If anything, the downfall of MCI WorldCom and others should strengthen the remaining viable carriers who will inherit additional

[18] Where a company engages in serious accounting fraud that is designed to mask its true financial state, the reported information relied upon by credit managers would likely show that no unusual credit terms or security deposits are needed. In this regard, it is significant to note that Verizon and the other large incumbent LECs are among the many suppliers (including AT&T) that have large claims against the MCI WorldCom estate. The tariff revisions that Verizon and other incumbent LECs seek would likely not provide additional security in cases where companies engage in fraud or other improper practices

customers Moreover, as described in Professor Cornell's declaration, the bankruptcy data presented by Verizon tends IO show that bad debt expense for the listed companies will generally *not* be occurring in the future Cornell Dec. ¶¶ 16-17. Indeed, Verizon admits that its had debt expense is related in part to the "recent economic downturn," and that any increase in uncollectibles "will slow." Direct Case at IS. Verizon nonetheless contends that its uncollectibles will continue to increase, but it offers not a shred of evidence to support that prediction (one that LECs have been crying wolf on for years ***(see** supra* note l)). In short, Verizon has not come close to meeting its burden of demonstrating that an overhaul of longstanding security deposit provisions is necessary to protect it from extraordinary and nontransitory increases in the risk of nonpayment by carrier customers for access services

B. Verizon's Existing Price Cap Rates Adequately Compensate It For The Risk of Uncollectibles.

Any expansion of Verizon's security deposit tariff provisions is both unnecessary and improper because the Commission's price cap regime already accounts for uncollectibles expense – and fluctuations in the levels of uncollectibles expenses – in the rates that Verizon may charge access customers. **As** the *Investigation* ***Order*** recognizes (**¶¶ 3,** 12), Verizon is a price cap carrier, and any year-to-year fluctuation in uncollectibles will either reduce or increase Verizon's profits, but, under the design of the price cap system, such fluctuations cannot entitle Verizon to assess higher rates. And by the same token, Verizon cannot circumvent this feature of price caps by adopting what is in effect a massive rate increase through new security deposit and advance payment tariff provisions that would radically alter the balance of risk as between Verizon and its captive access customers.

The *Investigation Order* specifically directed that "[a]s part of its direct case, Verizon shall explain why it believes its rates under price caps do not adequately compensate it for the risk of uncollectibles."" As the *Investigation Order* explained, "Veriron's rates include a revenue requirement component for uncollectible debts that is based on the amount of uncollectibles permitted as an interstate revenue requirement at the time Verizon became subject to price cap regulation."[20] The *Investigation Order* directed Verizon to submit data as to the "level of uncollectibles that was included in its initial price cap rates," and then to "address whether the variation in uncollectible levels for 2000 and 2001 is merely a normal fluctuation in uncollectibles, which would be covered by the business risks expected to be endogenous to price caps, or whether it reflects some long term trend that warrants expanded security deposits."[21] In addition, the *Investigation Order* required Verizon to "address what modifications should be made to its price cap indexes and service band indexes to account for the changes to the capital and risk parameters of price caps" that would occur if the Commission were to permit changes to Verizon's access tariff to include expanded security deposit discretion.*'

Verizon's Direct Case provides no serious response to the *Investigation Order's* inquiries. Verizon asserts, without citation or other support, that "[t]he current uncollectible revenue situation for access revenues cannot be considered endogenous to price caps."[23] That *ipse dixit* is not a reasoned response to the Commission's inquiry.

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19 *Investigation Order* ¶ 12

20 *Id.*

21 *Id.*

22 *Id.*

23 Direct Case at 12

In fact, any fluctuations in the year-to-year level of uncollectibles are simply business risks that are endogenous to the price cap regime[24] Actual levels of uncollectibles expenses – like actual levels of *all* expenses – will vary over time, depending upon factors such as general economic conditions and the LECs' own efficiency in collecting bad debts. In years where economic conditions are poor, and where uncollectibles in fact rise, a LECs' profits, all other things being equal, will be reduced. On the other hand, when economic conditions improve and where uncollectibles fall, a LECs' profits can be expected to be greater[25] The very purpose of the price cap regime is to hold rates and other terms constant in the face of expense fluctuations to increase the LEC's incentives to act efficiently.[26]

As the ***Investigation Order*** recognizes (¶ 3), under the price cap regime, a LEC experiencing a rise in uncollectibles must demonstrate either that the increase is due to a change in exogenous costs, ***i.e.***, some "administrative, legislative or judicial action beyond the control of the carriers,'"' or that their earnings are low enough to justify an above-cap filing.[28] Verizon has not sought an exogenous cost change, and it also **has** not

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[24] ***See Investigation Order*** ¶ 12.

[25] In a number of years since price caps were instituted in 1990, Verizon and a number of LECs experienced very low uncollectible rates because of economic and other conditions. Their profits in those years were likely larger because they had very little bad debt. However, Verizon and the other incumbent LECs have never come forward at those times to relax credit terms to make them more favorable to customers.

[26] Indeed, Verizon concedes as much, admitting that a cause of the modest increase in uncollectibles is the "recent economic downturn," and recognizing that that "the trend" in uncollectibles may "slow." Direct Case at 14.

[27] ***In the Matter of*** *Policy and* ***Rules Concerning Raiesfor Dominant Carriers,*** *5* FCC Rcd. 6786, ¶ I66 (1990)

[28] ***Investigation Order*** ¶ 3

even attempted to demonstrate that recent fluctuations in uncollectibles expense have been so extreme that existing rates and tariff provisions will prevent it from earning a just and reasonable return – a showing that it could not make given its exorbitant returns.[29]

Given the price cap regime, the *Investigation Order* required Verizon to demonstrate, at a minimum, that any changes in its uncollectibles constitute a long-term trend, rather than a simple change in the business cycle or a reduction in its own efficiency in collecting bad debts.[30] Verizon has not made that showing. As described above, Verizon's uncollectibles expense has fluctuated over time – variability that is entirely consistent with business cycles and other short-lived events. Moreover, the very difficulties in the telecommunications industry over the past few years that Verizon claims require relief will help reduce the risk of bad debt expense going forward. As Professor Cornell describes, given the capital market conditions, few new **firms** (and even fewer financially unstable firms) will be entering telecommunications markets. Cornell Dec. ¶ 17. And the firms that have declared bankruptcy – which are more likely the ones that made the "poor business plans" about which Verizon claims[31] – will either cease to exist or will emerge from bankruptcy with little or no debt and thus will not present extraordinary future risk of non-payment. Cornell Dec. ¶¶ 16-17; *cf.* Verizon Exh **A** at **A-25** ("[t]he current period probably reflects an accelerated shakeout of unsuccessful

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[19] In fact, granting Verizon relief here would provide a graphic illustration of why price caps do not eliminate the incumbent LECs' incentives to reduce costs. The incumbents would be secure in the knowledge that, despite the price cap system, they can request regulatory relief to obtain higher rates (or their equivalent – such as the increased security deposits at issue here) in circumstances where the strict application of price caps would reduce their earnings.

[30] *Investigation Order* ¶¶ 3, 12, 16

[31] Direct Case at 15